INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes and regulations involved	2
Statement	2
Argument	5
Conclusion	10
Appendix	11

CITATIONS

Cases:	
August v. *Commissioner*, 267 F. 2d 829, affirming 30 T.C. 969	7
Braunstein v. *Commissioner*, 374 U.S. 65	5, 6
Burge v. *Commissioner*, 253 F. 2d 765	7
Glickman v. *Commissioner*, 256 F. 2d 108	7
Mintz v. *Commissioner*, 284 F. 2d 554	7
Payne v. *Commissioner*, 268 F. 2d 617	7
Short v. *Commissioner*, 302 F. 2d 120	7
Sorin v. *Commissioner*, 271 F. 2d 741, affirming *per curiam* 29 T.C. 959	7
Spangler v. *Commissioner*, 278 F. 2d 665, certiorari denied, 364 U.S. 825	7, 8
Statutes:	
Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)):	
Sec. 111	9
Sec. 115	9
Sec. 117(m)	2, 4, 5–9
Internal Revenue Code of 1954 (26 U.S.C.):	
Sec. 312(j)	10
Sec. 341	5

407-425—70

Miscellaneous:

H. Rep. No. 2319, 81st Cong., 2d Sess. 5
Message from the President Transmitting Request for a Revision of the Tax Laws, H. Doc. No. 451, 81st Cong., 2d Sess. 5
S. Rep. No. 2375, 81st Cong., 2d Sess. 5
S. Rep. No. 1622, 83d Cong., 2d Sess. 10
Treasury Regulations 118, Sec. 39.117(m)-1 ..... 2, 8-9, 11

In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 771

LOUIS BENEDEK and JANET BENEDEK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

HENRY HIRSCH and MYRTLE G. HIRSCH, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ALEXANDER P. HIRSCH and MARY E. HIRSCH, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

MARTIN H. BENEDEK and LEONORE BENEDEK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 1a–13a) are reported at 50 T.C. 732. The

opinion of the court of appeals (Pet. App. 14a–19a) is not yet reported.

JURISDICTION

The judgments of the court of appeals were entered on July 1, 1970. The petition for a writ of certiorari was filed on September 29, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Whether the courts below correctly sustained the Commissioner's determination that gains realized by petitioner-stockholders from cash distributions from collapsible corporations were attributable to property constructed by the corporations, with the result that the gains were taxable as ordinary income rather than as capital gains.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 117(m) of the Internal Revenue Code of 1939 are set forth in Appendix C to the petition (Pet. App. 20a–22a).[1] The pertinent provisions of the Treasury Regulations (Section 39.117(m)–1 of Treasury Regulations 118 (1939 Code)) are set forth in the Appendix, *infra*, pp. 11–12.

STATEMENT

Petitioners[2] in 1949 organized five New York corporations ("Farragut corporations") for the purpose

[1] Unless otherwise stated, all references are to the Internal Revenue Code of 1939.

[2] Louis Benedek, Henry Hirsch, Alexander Hirsch, and Martin Benedek are referred to as the petitioners, since their wives are parties only because joint income tax returns were filed. The cases were consolidated for hearing and decision in both courts below.

of leasing an unimproved tract of land from another corporation (Newstrand Realty) and constructing apartment housing projects financed through mortgages insured by the Federal Housing Administration (FHA).[3] Five leases from Newstrand to the Farragut corporations were executed in accordance with FHA requirements, each for a term of 99 years and renewable at the option of the lessee for an additional 99 years. The leases provided that should the mortgagee or the FHA as mortgage insurer acquire title to the leaseholds by reason of a default by the mortgagors, the mortgagee or the FHA could acquire the lessor's fee upon payment of a "recapture price" totalling $1,924,000. (Pet. App. 3a–5a, 15a–16a.)

Mortgages in the total amount of $21,719,300 were negotiated by the Farragut corporations with Manhattan Company and were insured by the FHA. Under FHA policy the amount of the insured mortgages was equal to 90 percent of estimated replacement cost of the constructed property. The value of the Farragut corporations' leaseholds did not influence the amount of the insured mortgage loans because it was not considered part of the replacement cost of the apartment buildings. (Pet. App. 5a, 16a.)

Between 1949 and 1951 the Farragut corporations constructed on their leaseholds 59 apartment buildings, at a total construction cost of $18,118,987 (Pet. App. 5a, 16a). During those years the corporations distributed to their shareholders $3,158,000, although

[3] Petitioners owned 75 percent of the stock of the Farragut corporations and Newstrand. Morris Kavy, not involved in this case, owned the other 25 percent. (Pet. App. 3a, 4a.)

they had no accumulated earnings and indeed suffered operating losses during this period (Pet. App. 5a–6a, 16a).

The leaseholds, for which the Farragut corporations had paid nothing, had at the time of the cash distributions to stockholders a fair market value of $1,517,333. No part of this market value was attributable to the construction of the apartment buildings on the leaseholds. (Pet. App. 7a, 10a–11a, 16a.)

Petitioners concede that the Farragut corporations were "collapsible corporations" as defined by Section 117(m) of the Internal Revenue Code of 1939, which provides that any gains on distributions to stockholders are taxable to them as ordinary income rather than as capital gains. However, petitioners claim that they come within the exception of Section 117(m)(3)(B), which provides that Section 117(m) is inapplicable unless more than 70 percent of the gain on a distribution is attributable to the constructed property, on the theory that more than 30 percent of the gains on the cash distributions was attributable to the increase in value of the leaseholds. Accordingly, they reported the gains as capital gains. The Commissioner determined that the gains on the cash distributions were attributable entirely to the constructed property, and were therefore taxable as ordinary income, and accordingly determined deficiencies for the taxable years 1950 and 1951 totalling $1,228,659.19. (Pet. App. 2a, 9a, 17a.) The Tax Court upheld the Commissioner's determination (Pet. App. 11a–13a), and the court of appeals affirmed (Pet. App. 17a–19a).

ARGUMENT

The decision below, affirming that of the Tax Court, is correct and is in accord with decisions in every other case involving substantially the same issue. Neither a conflict nor an important question is presented.

1. Petitioners attempt here to revive an issue which has long since been put to rest in similar "FHA windfall" cases involving cash distributions by a "collapsible corporation" to its stockholders out of surplus proceeds of FHA approved construction loans. Essentially the same argument which petitioners advance in an effort to bring their admittedly "collapsible corporation" within the limitation provision of Section 117(m)(3)(B) of the 1939 Code, so as to render the gain realized from the distribution taxable as capital gain rather than ordinary income, has repeatedly been rejected by the courts.

Prior to the enactment of Section 117(m) of the 1939 Code, stockholders who formed a corporation in order to construct property were able to extract the anticipated corporate profits at capital gain rates through a distribution by the corporation (or a sale or exchange of their stock) before the corporation had realized substantial net income from the project. To prevent this result Congress in 1950 added Section 117(m) to the 1939 Code (now 1954 Code Section 341).[4] The section is divided into three parts: sub-

[4] Message from the President Transmitting Request for a Revision of the Tax Laws (January 23, 1950), H. Doc. No. 451, 81st Cong., 2d Sess., p. 5; H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 56–57, 96; S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 45, 88. See *Braunstein* v. *Commissioner*, 374 U.S. 65, 68–71.

section (m)(1) taxes gain from a sale of stock of or a distribution from a "collapsible corporation," which would otherwise be taxable as capital gain, as ordinary income; subsection (m)(2) defines a "collapsible corporation" as one formed or availed of principally for the construction of property with a view to a distribution that would enable the stockholders to realize gain attributable to the constructed property prior to realization by the corporation of a substantial part of the net income to be derived from such property; and subsection (m)(3) places certain limitations on the application of the section. We are here concerned solely with the limitation provision of Section 117(m)(3)(B), which provides that Section 117(m) "shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the [constructed] property." In *Braunstein* v. *Commissioner,* 374 U.S. 65, 70, this Court stated that the "phrase 'attributable to' merely confines consideration to that gain caused or generated by the property in question."

In harmony with the scheme of Section 117(m), its legislative history, the implementing Treasury Regulations (Appendix, *infra,* pp. 11–12), and the relevant decisions, both courts below correctly held that Section 117(m)(3)(B) is inapplicable to the instant case. It is undisputed that the Farragut corporations which the petitioners-stockholders formed to construct apartment houses were "collapsible corporations" as defined in Section 117(m); that the corporations made cash distributions to petitioners during the taxable years (1950 and 1951) out of the surplus proceeds of

FHA insured construction loans, *i.e.*, out of the borrowed amounts in excess of the actual construction costs; and that petitioners realized gains from such distributions. The Commissioner's determination that the entire gains were "attributable to the [constructed] property," and that consequently Section 117(m)(3)(B) was inapplicable, is in complete accord with the decisions in a series of cases presenting the same issue, and was properly sustained by the courts below. *Glickman* v. *Commissioner,* 256 F. 2d 108, 111 (C.A. 2); *Mintz* v. *Commissioner,* 284 F. 2d 554, 559–560 (C.A. 2); *Sorin* v. *Commissioner,* 271 F. 2d 741 (C.A. 2), affirming *per curiam* 29 T.C. 959; *Payne* v. *Commissioner,* 268 F. 2d 617, 621 (C.A. 5); *Burge* v. *Commissioner,* 253 F. 2d 765, 769–770 (C.A. 4); *Spangler* v. *Commissioner,* 278 F. 2d 665, 670 (C.A. 4), certiorari denied, 364 U.S. 825; *Short* v. *Commissioner,* 302 F. 2d 120, 124–125 (C.A. 4); *August* v. *Commissioner,* 267 F. 2d 829 (C.A. 3), affirming 30 T.C. 969, 986–987.

Here, as in the cited cases, the corporate distributions were made in cash out of surplus proceeds of construction loans; and here, as in those cases, all of the resulting gains realized by the recipient stockholders were attributable to the construction project, not to appreciation in the value of the land or leasehold on which the property was constructed. As both courts below held, and other courts have pointed out in similar cases (*e.g., Glickman* v. *Commissioner, supra,* p. 111; *Payne* v. *Commissioner, supra,* p. 621; *Mintz* v. *Commissioner, supra,* pp. 559–560; *Short* v.

Commissioner, *supra*, pp. 124–125), but for the construction there would have been no excess of loan proceeds over construction costs; but for such excess there would have been no cash distribution; and but for such cash distribution the taxpayers would not have realized the gains in question. Under the applicable decisions, not merely "more than 70 per centum of such gain," but *all* of such "gain" was "attributable to the [constructed] property" within the meaning of Section 117(m)(3)(B), thus rendering that limitation provision inapplicable.

2. Petitioners do not and cannot assert conflict with any other decision. Indeed, as shown by the above cited cases, the courts have uniformly rejected the interpretation of Section 117(m)(3)(B) urged by petitioners. There is no more reason for further review of the decision below than, for example, of the decision in the *Spangler* case, *supra*, in which certiorari was denied.

3. There is no merit in petitioners' contention (Pet. 7–8) that the decision below contravenes the applicable Treasury Regulations. See Section 39.117(m)–1(e) of Regulations 118 (1939 Code), Appendix, *infra*, pp. 11–12. Rather it is petitioners who would misapply them. The portion of the Regulations upon which petitioners rely (Section 39.117(m)–1(e)(3)(ii)) states that, for purposes of applying the 70 percent rule contained in 1939 Code Section 117(m)(3)(B), "the gain attributable to the [constructed] property * * * is the excess of the recognized gain * * * over the recog-

nized gain which the shareholder would have if the property had not been * * * constructed." Nothing in this statement or elsewhere warrants petitioners' self-serving assumption that the cash distributions they received from the Farragut corporations out of the surplus construction loan proceeds did not result in recognizable gain "attributable to the [constructed] property" within the purview of Section 117(m)(3)(B) and the Regulations. For gain to be "recognized" it must first have been "realized."[8] While petitioners may have had an unrealized gain attributable to appreciation in the value of the leaseholds upon which the constructed property (apartment houses) was placed, at no time during the taxable years was such appreciation converted into realized gain. In the words of the very regulation upon which petitioners rely, there simply was no "recognized gain which the shareholder [petitioners] would have [had] if the property had not been * * * constructed." See also, Section 39.117(m)-1(c)(3)(iii) of Regulations 118, Appendix, *infra*, p. 12. The only recognizable gain was the gain realized from the cash distributions made from the surplus construction loan proceeds. But for the construction loans, the Farragut corporations would have had no money to distribute, and the gain realized and recognized by petitioners on the cash distributions was

[8] The recognizable gain was the excess of the cash amounts distributed over petitioners' bases for their stock. See 1939 Code Sections 111, 115. The bases for their stock was zero (Pet. 7), and they reported the entire amount of the distributions as capital gains (Pet. App. 17a).

therefore "attributable" entirely to the "constructed property."[*]

4. The issue here presented, which arises under the 1939 Code, lacks importance for the future in view of the enactment of 1954 Code Section 312(j). That section specifically provides that a corporate distribution of the proceeds of a loan insured by the United States shall be taxable as ordinary income if the amount of the outstanding loan exceeds the adjusted basis of the property securing the loan. See S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 47, 251, 260.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

JOHNNIE M. WALTERS,
Assistant Attorney General.

HARRY BAUM
DAVID ENGLISH CARMACK,
Attorneys.

OCTOBER 1970.

---

[*] Even assuming *arguendo* that some percentage of the gains in question was attributable to an increase in value of the land or leaseholds on which the property was constructed, the decision below is nevertheless entitled to affirmance on the separate ground—alternatively relied upon by the Tax Court (Pet. App. 11a)—that petitioners failed to meet their burden of proving that at least 30 percent of the gains was attributable to appreciation in land or leasehold values.

APPENDIX

Treasury Regulations 118 (1939 Code):

§ 39.117(m)-1 *Collapsible corporations*—(a) *In general.* Subject to the limitations contained in paragraph (c) of this section, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115(c), as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115(d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

* * * * *

(c) *Limitations on application of section*—(1) *General.* * * *

* * * * *

(3) *Seventy-percent rule.* (i) This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117(m)(2)(A). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

(ii) For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is the excess of the recognized gain of the shareholder during the

taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115(d), the gain attributable to the property shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

(iii) Gain may be attributable to the property referred to in section 117(m)(2)(A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1970